Business Financial Management

Session 1

Differences between Profit & Loss and Cash Flow

Revenue and Expense Trends

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Presentation Overview

- Understanding the three main financial statements
  - What is contained on each
  - How we can use that data to determine the financial health of our business
  - Most valuable when we have a time-series for comparison purposes
- Assessing Revenue Trends
- Budgeting Expenses

Profit & Loss Statement (P&L)

- Definition: "The financial statement presenting the revenues and expenses of a business for an accounting period"
  - "Are we making money?"
- Also called the Income Statement
- First page of your business tax return is basically a P&L
- Most commonly understood and used financial statement
- Ignores certain areas that have a significant impact on cash flow
  - Profits do not always equal positive cash flow!

Types of Accounting

- Cash Basis of Accounting
  - Recognizes revenue when it is **collected** and expenses when they are **paid**
- Accrual Basis of Accounting
  - Recognizes revenue when it is **earned** and expenses when they are **incurred**
- Implication of each regarding financials statements
  - Cash Basis easier, but Accrual more accurate
- Assumption that we are using Accrual Basis

Cash Flow Statement

- Definition: "The financial statement that provides information about the cash inflows and outflows from operating, financing and investing activities"
- "Where is the money coming from and where is it going?"
- Broader range of information than the P&L Statement

Cash Flow Statement

- Especially useful in Accrual based accounting
- Tracks Cash Flow:
  - from Operating Activities
    - Profits + Depreciation/Amortization +increase in A/P - increase in A/R – increase in inventory
  - from Investing Activities
    - Outflow (negative number) due to purchase of long-term assets
  - from Financing Activities
    - Inflow from proceeds of loans obtained or stock issued
    - Outflow due to principal repayment on debt or dividends issued

P&L versus Cash Flow

P&L	
Sales	$100,000
- COGS	-$40,000
- SG&A	-$35,000
- Interest	-$10,000
- Depreciation	-$5,000
Profit Before Tax	$10,000
- Tax	-$2,000
Net Profit	**$8,000**

Cash Flow		
Cash Flow from Operating		
Net Profit	$8,000	
+ Depreciation	$5,000	
+ Increase in A/P	$3,000	(Vendors extended looser credit or volume of use increased)
- Increase in A/R	-$5,000	(We didn't collect as fast, or sales grew and we collected same rate)
Total Cash Flow from Operating	**$11,000**	
Cash Flow from Investing		
- Long term Equipment Purchased	-$20,000	(Delivery Van)
Total Cash Flow from Investing	**-$20,000**	
Cash Flow from Financing		
- Principal Repaid on Existing Loan	-$8,000	(Total Loan Payments are $1500/mo)
+ New loan obtained on van purchase	$15,000	
Total Cash Flow from Financing	**$7,000**	
Total Cash Flow	**-$2,000**	

Balance Sheet

- Definition: "The financial statement that shows the financial condition of a company on a particular date"
  - "Do you own more than you owe?"
- Used to reconcile the results of the Profit & Loss Statement with the operating, investing and financing activities of the Cash Flow Statement

Assessing Revenue Trends

- To provide as accurate a forecast as possible, we should take into account seasonality and trends
- Seasonality patterns:
  - Internal monthly financials
    - More specific to your customers and geography, but more sensitive to wide fluctuations; perhaps average multiple years
  - SD Department of Revenue Sales Tax Statistics
    - www.state.sd.us/drr2/businesstax/statistics/statistics.htm
    - Broader geography, but more sources provide less fluctuations
    - One month delay in publication date versus calendar date
  - Industry Statistics
    - Census Bureau, National Associations and Trade Journals
    - Widest geography
- Proration of partial year sales when forecasting year-end sales should take into account the normal contribution for the same period

Assessing Revenue Trends

How do we measure changes in sales and use this to forecast?

- Simple Sales Growth
  - year-over-year or month-over-month; sliding 12 months
  - easiest in stable businesses and industries
  - $400,000 (2008), $440,000 (2009)…$484,000? (2010)
- Market Share
  - what % of the market do you capture? How has this changed?
    - Sales could be up, but market share down and vice-versa
  - $400,000 (2008), $440,000 (2009)
  - Industry: $4,000,000 (2008), $6,300,000 (2009)
  - Market Share: 10% (2008), 7% (2009)

Assessing Revenue Trends

- Changes in your Product Mix
  - if you sell multiple products, has there been a shift in demand for certain areas? Are customers moving to higher or lower margin products?
    - Same sales volume could be generating a greater or lesser amount of profit margin

Assessing Revenue Trends

- Changes in your Product Mix

	Units	Price	Cost %	Revenue	Cost	Gross Profit
New Cars	60	$35,000	90%	$2,100,000	$1,890,000	$210,000
Used Cars	30	$15,000	84%	$450,000	$378,000	$72,000
Repair			50%	$200,000	$100,000	$100,000
Warranty Commissions	9	$500	0%	$4,500	$0	$4,500
				$2,754,500		**$386,500**

	Units	Price	Cost %	Revenue	Cost	Gross Profit
New Cars	30	$35,000	90%	$1,050,000	$945,000	$105,000
Used Cars	60	$15,000	84%	$900,000	$756,000	$144,000
Repair			50%	$200,000	$100,000	$100,000
Warranty Commissions	18	$500	0%	$9,000	$0	$9,000
				$2,159,000		**$358,000**
					Difference:	**-$28,500**

Assessing Revenue Trends

- Changes in Key Customers
  - Are your sales concentrated to a few key customers? What are the risks? How have their order volumes been changing?
    - If sales are increasing, is it more customers, more sales per customer or a combination? Is the customer buying more quantity, more often, or additional product lines? Are your sales concentrating to fewer customers or products?
- "Same Store Sales"
  - Tries to assess apples-to-apples sales comparison (chain growth versus individual store growth)
- Industry specific trends (gasoline retail: gallons)

Assessing Revenue Trends

- Four tenets of growth:
  - Increase price per unit
    - Inflation, additional features
  - Increase number of customers
    - population growth
    - market share gain
    - shifting consumer behavior
  - More visits per customer
  - More product purchased per visit
    - volume of purchase
    - cross-sell other products

Budgeting Expenses

- Two main types of expenses
  - Variable: expenses that fluctuate with sales
    - Franchise Fees, Royalties, Credit Card Fees, Inventory (when using accrual accounting)
  - Fixed: expenses that tend to be more independent of sales
    - Regular: Owner Salary, Rent, Insurance
    - Irregular: Utilities (weather and rate driven), Repairs
    - Periodic: Trade Shows, Year-end Tax Prep, Dues
    - Non-Cash: Depreciation & Amortization
- Labor…fixed or variable?
  - Salaried generally considered Fixed; Hourly could be either Fixed or Variable

Budgeting Expenses

- Variable Expenses should maintain a relatively consistent percentage of revenue
  - If a Variable Expense is increasing as a percentage of revenue, it should be investigated
- Fixed Expenses should maintain a relatively consistent dollar figure
  - Adjusted for inflation (insurance, wage rates)
  - Adjusted for contractual obligations (rent)
  - Some expenses periodically "stair-step"
    - With sales growth, may have to move to a new, larger building or hire additional staff
  - If a Fixed Expense is growing faster than the overall rate of inflation, why is it happening? Is it a sign of a problem?
  - If a Fixed Expense is increasing as a percentage of sales, this should be investigated immediately!
    - Logical cause: flat or declining sales with fixed expenses growing due to inflation

Other Budgeting Issues

- Do not neglect to calculate reasonable owner salary into your budget
  - Generally not tax deductable as a Sole-Proprietorship, LLC or Partnership, but still needs to be factored into the budgets for a realistic view of cash flow
  - If a corporation and drawing income through a combination of paycheck and dividend, do not neglect the dividend portion in your budget if relied on for personal living expenses
- P&L captures only the interest expense on the loan; Cash Flow statement captures interest & principal
- Owner injection of capital is not revenue
- Profits do not always equal cash flow and cash flow is king!

Sessions

- Thursday, July 15th: Session 1 10am
  - Difference between P&L and Cash Flow / Revenue and Expense trends
- Thursday, July 22nd: Session 2 10am
  - Building a Budget / Loan Programs / Banker's View
- Thursday, July 29th: Session 3 10am
  - Business Financial Ratios / Calculating Break Even Points
- These series and prior series are digitally archived at www.sba.gov/sd
  - Survive & Thrive Series
  - Marketing Matters Series